STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**08/14/00**	Bill No:	**AB 599**
Tax:	**Sales and Use**	Author:	**Lowenthal**
Board Position:	**Support**	Related Bills:	

BILL SUMMARY:

This bill would enable a retailer, including an affiliate of the retailer, or lender, under specified conditions, to claim a bad debt deduction for sales or use tax paid on transactions on accounts held by a lender that are determined to be uncollectible.

ANALYSIS:

Current Law:

Under existing law, all retailers are required to report their sales tax liability on an accrual basis. Sections 6055 and 6203.5 of the Sales and Use Tax Law, however, relieve a retailer from the liability for sales or use tax on transactions that were reported on a retailer's sales tax return but which were subsequently found to be worthless and written off for income tax purposes. If a retailer is not required to file income tax returns, the law allows a bad debt deduction if the amount has been charged off in accordance with generally accepted accounting principles. The law specifies that if a retailer subsequently collects any amounts for which a bad debt deduction is claimed, the amount so collected is required to be reported and paid to the Board on the first return subsequently filed with the Board.

Proposed Law:

This bill would amend Sections 6055 and 6203.5 of the Sales and Use Tax Law to do the following:

- Allow entities affiliated with a retailer to claim a bad debt deduction on accounts found worthless that the retailer originally reported as taxable sales on the retailer's sales and use tax returns.
- Allow a lender, as described, or a retailer, to make an election, as specified, to claim a bad debt deduction or refund for accounts that were reported as taxable by the retailer but subsequently found to be worthless.
- Specify that the contract between the retailer and the lender contain an irrevocable relinquishment of all rights to the account from the retailer to the lender.
- Require the party making the election to claim the deduction or refund to file a claim in a manner prescribed by the Board.
- Specify that if the retailer claimed the bad debt deduction, and collects in whole or in part any account, the retailer shall report that amount on its next sales and use tax return.

- Specify that if the lender claimed a refund or deduction, and collects in whole or in part any account, the lender shall pay the tax in accordance with Section 6451.

The bill would become effective January 1, 2001, and would apply to any tax remitted on or after January 1, 2000.

<u>In General:</u>

Businesses involved with credit sales often sell their receivables or use "private label credit cards." Accounts receivable can be sold with recourse or without recourse. "With recourse" means the purchaser of the debt may give the debt back to, or has recourse against, the retailer if the debt cannot be collected. Generally, sellers selling accounts with recourse receive a better price for these accounts receivable than accounts sold without recourse because there is less risk to the purchaser. Accounts receivable sold with recourse and later returned to a retailer are allowable as a bad debt deduction to the retailer for any portion of the loss on the sale which represents a previously reported taxable sale.

Accounts sold "without recourse" are debts in which the purchaser of the accounts receivable (assignee) accepts all the risks for collecting the debt and cannot return the debt to the seller. The sale of the debt is a separate financial arrangement between a retailer and an assignee, and the Sales and Use Tax Law does not recognize any accounts subsequently not collected by the assignee as amounts qualifying as "bad debts" of the retailer. In other words, since the retailer sells the debt and does not suffer any losses by virtue of nonpayment by the customer to the assignee, there can be no bad debt deduction claimed by the retailer, even if the customer fails to pay the full amount due to the assignee. Further, an assignee of an account is not entitled to a bad debt deduction for amounts uncollected because the assignee was not involved in the retail sales transaction.

This is true in cases where a retailer uses a "private label credit card." Private label credit cards generally are credit cards in which a financing company extends credit to the customers of a retailer', with the name of the retailer shown on the face of the card. The financing company mails statements, collects the payments, finances and owns the receivables, and suffers any losses in the collection processes. Under current law, the retailer is not be entitled to claim a bad debt deduction when an account is determined to be worthless by the financing company.

<u>Background:</u>

A similar measure was considered in the 1997-98 Legislative Session. That measure, AB 1229 (Migden) was held in the Senate Appropriations Committee. The Board voted to support AB 1229.

COMMENTS:

1. **Sponsor and purpose of the bill.** According to the author's office, this bill, co-sponsored by GE Capital Corporation and the California Retailers Association, is intended to correct the current competitive disadvantage for those retailers who sell their receivables without recourse or who use private label credit cards. Since the

selling price of the accounts includes the sales tax, a lender's or assignee's loss on nonrecourse debt is, on average, 7.89% higher than the loss to a retailer, who can at least recoup the sales tax through a deduction or a refund of the sales tax on those accounts found to be worthless. This measure is intended to allow a lender to obtain a refund of sales and use tax on uncollectible accounts, if the contract between the retailer and lender so provides. This effectively reduces the lender's bad debt losses by an average of 7.89%, which would, in turn, allow the retailer to either obtain a higher selling price for the nonrecourse debt it sells, or incur a lower cost in using a private label credit card system.

2. **August 14, 2000 amendments would apply to tax remitted by retailers on or after January 1, 2000.** In the previous version of this measure, the bill would have provided that the deduction or refund of the tax that the retailer has previously reported and paid would apply to tax remitted on or after *January 1, 1999*.

3. **September 8, 1999 amendments are similar to the May 28, 1999 version.** These amendments enable either the retailer or the lender to obtain the refund, or claim credit for the sales tax paid on the bad debts, which was essentially the same language that appeared in the May 28, 1999 version.

4. **Reasoning behind current bad debt provisions.** For the privilege of selling tangible personal property at retail, current law imposes a tax upon a retailer. The retailer is responsible for reporting and paying the retail sales tax. Current law allows a retailer to claim a bad debt deduction for previously reported taxable sales if he or she does not receive total compensation for the retail sale transaction. If a retailer only collected a portion of the amount reported as taxable, a partial deduction may also be claimed for that portion found to be uncollectible.

5. **Currently, lenders and purchasers of accounts receivable are generally not required to register with the Board.** An assignee is a person who purchases the rights to a debt and thereby becomes the person to whom a debt is owed. A lender, as defined in the bill, would include both assignees and persons who hold a retail account pursuant to a contract with a retailer. These entities generally not engaged in the business of selling tangible personal property and therefore are not registered with the Board as sellers.

COST ESTIMATE:

Although Board staff could include the verification of bad debts claimed by retailers for assigned accounts as part of the regular audit process, there would be additional audit workload in verifying the accuracy of the lenders' bad debt claims/deductions. In addition, there would be additional audit workload in connection with verifying whether the lender remitted the tax attributable to amounts collected subsequent to the time the lender claimed a bad debt deduction. Additional costs would be incurred in identifying lenders and affected retailers, preparing a special notice to these taxpayers, amending the Board's regulation, and answering inquiries from taxpayers. These costs are expected to be absorbable.

REVENUE ESTIMATE:

Credit can be obtained in many ways, e.g., through national credit cards such as Master Card or Visa, revolving lines of credit through charge accounts offered by retailers, and fixed term contracts on specific purchases. Only receivables resulting from credit extended by retailers, either in the form of revolving lines of credit or fixed term contracts on specific purchases, and then sold without recourse would be covered by the provisions of this bill. These receivables represent a relatively small portion of total credit extended. However, since the total amount of credit extended is so large, even a relatively small portion of that total can be in the millions of dollars.

We examined the deduction for bad debts claimed on the tax returns of a number of large retailers claiming this deduction. The bad debt deduction averaged 2.0% of the total taxable sales of those accounts. To illustrate the potential effect of this bill, consider the possibility of a major retailer assigning receivables without recourse. Major department store chains tend to have annual taxable sales in the $1 billion to $2 billion range, depending upon the number of locations they have. If the worthless accounts of one such chain, amounting to 2% of its annual sales of $1.5 billion, were to fall under the provisions of this bill, the annual reduction in sales and use tax revenue attributable to that one chain would be $2.4 million.

One of the larger assignees has indicated that they handle the receivables for two of the major department store chains and several other major retailers, whose 1995-96 taxable sales totaled $3,842 million. Applying the 2% bad debt ratio against those sales gives estimated bad debts of $76.8 million, the tax on which would be $6.1 million.

There are also many other consumer-oriented retailers selling “big ticket” items, such as electronics, appliances, and furniture, that extend substantial amounts of credit and are likely to sell their receivables, some of which would be without recourse. Most vehicle financing is done directly between the buyer and either a lending institution or the financing arm of the vehicle manufacturer. However, some financing is transacted between the buyer and the dealer. In addition to consumer purchases, sales to businesses by agricultural equipment dealers, building materials retailers, and manufacturers and wholesalers frequently involve extension of credit, some of which may be assigned without recourse, that would fall under the provisions of this measure.

Revenue Summary

We identify a minimum annual revenue loss of at least $6 million for accounts receivable handled by the assignee referenced above. Additional loss for other retail stores, vehicle dealers, agricultural equipment dealers, building material outlets, and manufacturers and wholesalers would most likely be incurred. It should be noted that if these bad debt losses were not sold without recourse, current law allows a retailer to claim these losses for a credit or refund of the sales tax paid.

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